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RUEHKV/AMEMBASSY KYIV PRIORITY 0153
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C O N F I D E N T I A L SECTION 01 OF 03 WARSAW 000490

SIPDIS

NSC FOR KRISTINA KVIEN, JEFF HOVENIER AND DAVID LIPTON;
TREASURY FOR STEPHEN WINN AND ERIC MEYER; COMMERCE FOR
HILLEARY SMITH AND JAY BURGESS

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TAGS: ECON EFIN PREL PL
SUBJECT: DAVID LIPTON IN WARSAW: EUROPEAN FINANCIAL
CONTAGION AND CRISIS IN UKRAINE

REF: A. WARSAW 253
¶B. WARSAW 288

Classified By: Economic Counselor Mike Sessums for reasons 1.4 (b,d).

This cable has been cleared by Treasury A/DAS Eric Meyer.

¶1. (C) Summary: NSC Senior Director David Lipton and Treasury,s Eric Meyer were in Warsaw April 28-29. They met with government and private sector finance officials to discuss the crisis, as well as with Finance Minister Rostowski and Foreign Minister Sikorski regarding the situation in Ukraine. Lipton warned the Poles of significant down-side risk for the European financial sector and the potential for contagion to spread from parent banks. Discussions focused on ways to address the regulatory mismatch faced by countries dominated by subsidiary banks and steps Poland was taking to tackle this at a regional level. On Ukraine, both Lipton and Sikorski expressed serious concern that Ukraine,s political system would not take the difficult steps necessary to pull the country out of crisis. End Summary.

Parent Banks: Ongoing Concern for Financial Contagion
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¶2. (C) Lipton painted a worrisome picture of the health of European banks in the medium-term as they are forced to adjust portfolios to Europe,s contracting economy. The Poles shared Lipton,s concerns that increasing weakness in European parent banks could cause a credit squeeze in economies such as Poland, where European-owned subsidiaries control the market along with the two major state-owned banks (REF A). While it is illegal in Poland for parent banks to interfere in local credit decisions, bankers and supervisory officials lamented the limitations of the regulatory regime in this regard. Supervisory officials admitted their difficulties in regulating banks with parents based elsewhere and bankers noted the many ways of working around the regulators. Former PM Jan Krzysztof Bielecki, head of Poland,s largest bank (Pekao, owned by Italy,s Unicredito), acknowledged that parent-imposed lending constraints were a real risk, having already been implemented in Poland, and remarked that Poles have 300 years of experience deftly subverting regulations.

¶3. (C) Finance Minister Rostowski described his efforts to address the subsidiary issue in the EU College of Supervisors) where Poland is supported by the Swedes in attempting to create an appeals process. The process as envisioned by the

Poles would include binding College arbitration on the European level in the case of a dispute between regulators of subsidiaries and their counterparts in the parent bank,s home country. Lipton did not know how successful this effort would be, but expressed support for Poland,s attempts to address these regulatory challenges on a regional level. Director of Financial Supervision Kluza expressed his concern that parent bank regulators could inadvertently pressure bank groups to pull capital from subsidiaries, even if their only intention were to increase lending at home.

¶4. (C) Kluza and Foreign Minister Sikorski reiterated the GoP,s request for a seat at the G-20 as a representative of transition economies and a well-managed financial sector dominated by subsidiaries. Lipton expressed his understanding but said there was simply no way. Lipton did, however, assure the Poles that we share their concern for this regulatory mismatch and would continue to support efforts to avoid protectionism and nationalism in bank regulation as well as national constraints (vis a vis subsidiaries) on any parent bank capitalization programs in Europe.

Domestic Risk

¶5. (C) Bankers were notably positive in their assessment of their own activities and portfolios and the overall prospects for Poland this year; but when pressed, they identified weaknesses. Large businesses can still access credit, albeit more expensively, and small enterprises largely self-finance

in Poland. However, medium-sized businesses lack ready access to credit in the current environment. The foreign exchange options question (REF B) was discussed in detail, with bankers and supervisory officials assuring Lipton that the problem, while serious, was manageable and increasingly limited in downside risk as time and zloty strengthening unwind the complex financial products. However, foreign exchange exposure could still hurt mortgage portfolios as well as corporate clients with foreign currency denominated loans, particularly if the zloty again comes under pressure at the same time that unemployment climbs and consumer spending weakens.

Stimulus: Poland Remains Conservative but Has Room

¶6. (C) Lipton spent some time defending the size of US stimulus to skeptical audiences. However, they seemed more receptive of our short-run spending push when put in the context of tackling our own long-term structural budget issues. Leszek Balcerowicz, economist and father of Poland,s transition "shock therapy," noted the GOP,s interest in tackling their own structural issues such as pension reform. All agreed that taking on structural issues reassured markets of stable, long-term debt prospects in spite of short-run deficits. Finance Minister Rostowski was coy about Poland,s deficit projections, but admitted they would need to return to the Sejm this summer because they will not meet the official deficit target.

¶7. (SBU) Ambassador Ashe hosted a lunch with the governing party (PO) co-founder and former presidential candidate Andrzej Olechowski. On stimulus, Olechowski noted that that the government will &stimulate8 to the extent that they raise the deficit. Olechowski expected Euro 6-7 billion in combined public and private roads spending in 2009, with EU funds disbursement accelerating in the second half of 2009. NOTE: The government estimates approximately PLN 17 billion (Euro 3.9 bln) in EU structural adjustment infrastructure spending concentrated in the last half of 2009; well over double last year,s amounts.

FM Sikorski: Ukrainians not up to the Task

¶8. (C) Foreign Minister Sikorski requested a briefing on Lipton,s trip to Kyiv in anticipation of his own possible trip the following week (NB: Sikorski and German FM Steinmeier subsequently convinced EU foreign ministers to send a "troika" mission to Kyiv in May). Lipton expressed serious concern for Ukraine,s financial sector. He noted that any additional negative shock could sink what is left of their banks. He urged Poland to support a concerted effort by European regulators to keep parent banks from pulling out of Ukraine. Parent banks were following the letter of their agreement with the government of Ukraine to increase capitalization rates, but were dramatically cutting assets and exposure, causing a credit crunch that could exacerbate problems.

¶9. (C) Lipton congratulated Sikorski on Finance Minister Rostowski,s efforts in ECOFIN and the EU, adding that Rostowski should push even harder on enforcing the capitalization pledges of European banks. Sikorski shared Lipton,s concerns for Ukraine,s political leadership, which seems incapable of rising to the twin challenges of controlling the budget and fixing the banks; particularly given the Prime Minister,s thin staff, gas subsidies, and oligarch feuding that clouds decisions over supporting banks. All were pessimistic on the prospects for a World Bank donors conference on Ukraine as well as Ukraine,s efforts to secure additional bilateral aid. Lipton stressed that the US will continue to support an IMF program robust in both size and conditionality.

¶10. (C) Deputy FM in charge of economics, Pawel Wojciechowski, formally raised a series of economic points seemingly for the record, rather than for discussion. Lipton acknowledged them and pointed out that all were moving along in appropriate forums. These included a series of investment disputes; Polish interest in buying US based

assets in the region such as AIG; and, interest in working through the G-20 and Financial Stability Board on new financial architecture. Conversation finally turned to Russia, where Lipton made the point that a more productive U.S.-Russian relationship was not a threat to Poland, noting "there is no zero-sum game." Sikorski answered and closed the meeting with a message on U.S. Russian relations: "Poland will react allergically (emphasis) to any secret U.S.-Russia deal."

Comment: Polish Support for Regional Solutions
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¶11. (C) Poland,s financial sector remains sound, with vulnerabilities. Regulators have no foolproof way to contain contagion spread through parent banks, should the European situation worsen and bank groups seek to contract lending in the region further. Loan portfolios will deteriorate as Poland's growth slips toward zero or even negative, and exchange rate exposure, while seemingly manageable in Poland's case, would have a quick, sharp impact on balance sheets if volatility returns to January levels. However, while they are late in arriving, Polish officials - particularly bank supervisors and the Minister of Finance - now seem sufficiently alert to these vulnerabilities and are notably more engaged than they were just a few months ago.

¶12. (C) Poland is working within the EU to support regional approaches to managing the financial crisis. It has a useful role to play in any new financial infrastructure discussions (even if not in the G20) as a well managed banking sector populated by subsidaries of foreign banks. Poland also shares our interest in bringing stability to Ukraine on the financial front, just as they push in the EU for greater political engagement through the Eastern Partnership. Lipton,s visit further focused the Poles' attention and

should create an opening to further coordination on all of these fronts.
ASHE